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Report to the Chairman, Subcommittee on Water, Power and Offshore Energy Resources, Committee on Interior and Insular Affairs, House of Representatives

37

WATER SUBSIDIES

Basic Changes Needed to Avoid Abuse of the 960-Acre Limit

GAO

United States
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Resources, Community, and
Economic Development Division

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The Honorable George Miller
Chairman, Subcommittee on Water,
Power and Offshore Energy Resources
Committee on Interior and
Insular Affairs
House of Representatives

Dear Mr. Chairman:

This report responds to your request that we review the implementation of the Reclamation Reform Act of 1982, as amended. Specifically, this report focuses on whether (1) the act's acreage limit is being implemented in a manner consistent with the statute and congressional expectations and (2) large farms have been reorganized since the act was passed to receive subsidized water on acreage that exceeds the legislatively mandated limit and, if so, how they have been reorganized.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies to interested parties and make copies available to others upon request.

This report was prepared under the direction of James Duffus III, Director, Natural Resources Management Issues, who may be reached at (202) 275-7756 if you or your staff have any questions. Other major contributors are listed in appendix III.

Sincerely yours,

J. Dexter Peach
Assistant Comptroller General

Executive Summary

Purpose

From 1902 to 1982, federal reclamation law and policy allowed the Department of the Interior's Bureau of Reclamation to provide relatively inexpensive, federally subsidized water to western farmers on up to 160 owned acres (320 acres for married couples). The law was silent, however, on leased acreage, and the Bureau provided subsidized water to some large farms consisting of thousands of acres of leased land.

Recognizing the need to limit the number of both owned and leased acres the federal government will help a farmer irrigate, as well as the need to increase the size of an economically viable farm from the turn of the century 160 acres, the Congress passed the Reclamation Reform Act of 1982. The Congress expected, among other things, to limit a farm's owned and/or leased land that is eligible to receive federally subsidized water to a maximum of 960 acres.

At the request of the Chairman, Subcommittee on Water, Power and Offshore Energy Resources, House Committee on Interior and Insular Affairs, GAO reviewed the act's implementation focusing on whether

- the Bureau is implementing the act's acreage limit in a manner consistent with the statute and congressional expectations and
- large farms have been reorganized since the act was passed to receive subsidized water on acreage that exceeds the legislatively mandated limit and, if so, how they have been reorganized.

Background

The 1982 act represents a fundamental change in reclamation law. It limits to 960 the maximum owned or leased acreage that an individual or legal entity, such as a partnership or corporation, can irrigate with subsidized water. Generally, owned land above the limit cannot be irrigated with federal water, and farmers must pay the full cost for water delivered to leased land over this limit.

To determine whether farms have been reorganized to receive subsidized water on more than 960 acres, GAO selected eight farms—four each from lists of farms in the state of Washington's Columbia Basin Project and California's Central Valley Project—that were larger than 960 acres before the 1982 act was fully implemented. The eight farms are not necessarily representative of all large farms throughout the West; however, they do provide examples of how large farms have been reorganized through partnerships, corporations, and trusts.

Results in Brief

Congressional expectations have not been met. The Reclamation Reform Act, as amended, and the Bureau's implementing regulations do not preclude multiple landholdings, each of which is within the act's 960-acre limit, to continue to be operated collectively as one large farm while individually qualifying for federally subsidized water. Some farmers have taken advantage of this loophole by reorganizing their farms into multiple, smaller landholdings to be eligible to receive additional federally subsidized water from the Bureau using various partnerships, corporations, and/or trust arrangements. For all practical purposes, these smaller landholdings continue to be operated collectively as single large farms, much as they were before being reorganized.

One consequence of these reorganizations has been a reduction in revenues to which the federal government would have been entitled if the multiple landholdings had been considered collectively as large farms subject to the act's 960-acre limit. This reduction in revenues likely will continue to occur annually under the existing act.

Since these reorganized farms do not violate the act's language, Bureau audits of the individuals or legal entities who own or lease individual landholdings have found and will likely continue to find them to be in compliance with the act's 960-acre limit. Although existing regulations do provide the Bureau with the latitude to charge farm operators who have an economic risk in farming multiple landholdings the full-cost rate for federal water delivered to over 960 acres, it has not done so for the two cases included in GAO's review that come under these regulations.

Principal Findings

Dichotomy Exists Between Congressional Expectations and Implementation

The Reclamation Reform Act's legislative history shows that the Congress expected the Bureau to provide federally subsidized water to a maximum of 960 acres of owned and/or leased land being operated collectively as one farm. The act, however, defines and uses the term "landholding" rather than defining and using the term "farm" or "farming operation" in establishing the acreage limit and is silent on whether multiple landholdings can be operated together as one farm while qualifying individually for federally subsidized water on up to 960 acres. The Bureau's implementing regulations are based on the 1982 law as written and do not reflect congressional expectations in the act's legislative history.

Large Farms Have Been Reorganized to Receive Subsidized Water on More Than 960 Acres

In two of the eight cases GAO selected, the farmers who had previously farmed large acreages had divested themselves of their leased land above 960 acres before April 1987 consistent with congressional expectations. However, in the six others, the owners or lessees had reorganized large farms into multiple, smaller landholdings to be eligible to receive additional federally subsidized irrigation water from the Bureau.

For example, one 12,345-acre cotton farm (roughly 20 square miles), operating under a single partnership, was reorganized into 15 separate landholdings through 18 partnerships, 24 corporations, and 11 trusts. However, indicators that the 15 landholdings continue to be operated as one large farm include (1) the four original partners continue to manage all 15 landholdings, (2) at least one of the four partners is either the president or vice president of the corporations that participate in the agricultural business decisions of 9 of the landholdings totaling about 8,000 acres, and (3) the 15 landholdings are operated with a single loan secured in common by their combined crops and other farm assets.

Farm Reorganizations Are Reducing Federal Revenues

One consequence of these farm reorganizations and other arrangements is that the federal government is not collecting the revenues to which it would be entitled if multiple landholdings being operated together were considered collectively as one large farm subject to the act's 960-acre limit. In the cases GAO reviewed, owners or lessees paid a total of about $1.3 million less in 1987 for federal water delivered by the Bureau than they would have paid if their respective multiple landholdings had been considered collectively as large farms subject to the act's acreage limit. Reduced revenues likely will continue to occur annually unless the act is amended.

Bureau Audits Will Likely Continue to Find General Compliance With the Act's 960-Acre Limit

Concerned that some farmers are not complying with the 1982 act's 960-acre limit, the Congress amended the act in 1987 to require the Secretary of the Interior to audit individuals or legal entities whose landholdings or farming operations exceed 960 acres. However, because the act defines and uses the term landholding rather than defining and using the term farm or farming operation in establishing the acreage limit, the Bureau has found and will likely continue to find multiple landholdings of not more than 960 acres each that are owned or leased by different individuals or separate legal entities to be in compliance with the act, even though they are, in reality, parts of larger farms.

On the basis of the Bureau's determinations to date, GAO believes that the Bureau's audits of farming operations also will find them to be in general compliance with the act's acreage limit. Although the Bureau has the latitude under existing regulations relating to leases to charge farm operators who have use and possession of the land and an economic risk in its operation the full-cost rate for federal water delivered to over 960 acres, it has not done so for two cases included in GAO's review that come under these regulations.

Recommendation to the Congress

GAO believes that the act must be amended if it is to meet congressional expectations of limiting federally subsidized water to no more than 960 acres of leased and/or owned land being operated as one farm or farming operation. Therefore, GAO recommends that the Congress amend the Reclamation Reform Act of 1982 to apply the act's acreage limit to farms and farming operations as well as to individual landholdings. Proposed legislative language to implement this recommendation is included in chapter 2.

Agency Comments

Interior agreed that some farmers have reorganized their farms into smaller holdings to maintain large farming operations while complying with the act's acreage limit and that the act must be amended if the amount of acreage that a farm operator may hold and irrigate with federally subsidized water is to be limited. However, Interior cautioned that it is not convinced that the Congress expected to apply the 960-acre limit to land being operated as one unit. GAO believes that by amending the act as GAO recommends, the Congress will make clear its expectations.

Interior also stressed that, in its view, the act's purpose was not to enhance revenues to the federal Treasury. GAO agrees. However, a reduction in federal revenues is one consequence of the farm reorganizations.

See chapter 2 and appendix II for further evaluation and explanation of Interior's comments.

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Abbreviations

ASCS	Agriculture Stabilization and Conservation Service
GAO	General Accounting Office

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Introduction

The Department of the Interior's Bureau of Reclamation plans, constructs, and operates water resource projects to, among other things, provide irrigation water to arid and semiarid lands in the 17 western states. Bureau projects provide irrigation water to an estimated 26 percent of western irrigated farm land. Construction, operation, and maintenance of these projects are financed with federal funds. The Bureau sells most of its irrigation water to 611 state-established water districts which contract with the Bureau to purchase and distribute the water to almost 10 million acres of farmland. In doing so, the Bureau, over time, recoups a portion of the federal government's investment in providing the water.

The Bureau Provided Subsidized Water to Unlimited Leased Land Until 1982

From 1902 to 1982 the Bureau provided relatively inexpensive federal water at rates that excluded any interest on the federal government's investment in the irrigation component of its water resource projects. Water delivered at these rates is referred to as "subsidized water" because the lost interest is viewed as a subsidy to farmers.

Until 1982 federal reclamation law allowed water to be delivered at subsidized rates to owned land of up to 160 acres.[1] The Bureau, although not provided for by reclamation law, permitted married couples who owned a farm to irrigate up to 320 acres with subsidized water.[2] Federal reclamation law was silent on leased acreage, and the Bureau provided federally subsidized water to some large farms consisting of thousands of acres of leased land.

Some farmers were also able to defer repayment of federal construction costs and full operation and maintenance expenses because their water districts had entered into long-term (up to 40 years), fixed-rate contracts with the Bureau. As the costs to operate and maintain the federal resource projects increased because of inflation, the Bureau applied the fixed-rate payments first to offset increased operation and maintenance expenses and then, if any funds remained, to repay federal construction

[1]The law also allowed farmers who owned more than 160 acres before they began to receive federal water to continue irrigating such "excess" land with subsidized water for up to 10 years, provided they entered into "recordable contracts" with the Secretary of the Interior. Under these contracts, farmers agree to sell their excess land within 10 years at Bureau of Reclamation-approved prices. Bureau-approved prices reflect the value of the land less any added value resulting from the availability of project water.

[2]Subsequent to the establishment of this policy, Public Law 86-684 (Sept. 2, 1960), commonly called the "Surviving Spouse Act," recognized the prior reclamation policy that increased the acreage limit to 320 acres for a husband and wife by providing that a surviving spouse could continue to irrigate up to 320 acres with federally subsidized water.

costs. Unreimbursed operation and maintenance expenses were added to the districts' debts to the Bureau along with applicable interest.

The Reclamation Reform Act of 1982 Represents a Significant Departure From Prior Reclamation Law

Recognizing the need to limit the number of both owned and leased acres the federal government will help a farmer irrigate as well as the need to increase the size of an economically viable farm from the turn of the century 160 acres, the Congress passed the Reclamation Reform Act of 1982 (43 U.S.C. 390aa to zz-1). This act represents a fundamental change in reclamation law and the first major modification to its acreage limitation provisions in over 60 years.

The 1982 act was expected to put an end to the Bureau providing federally subsidized water to farms consisting of thousands of leased acres. It increases the acreage limit from 160 owned acres to 960[1] owned or leased acres that an individual or legal entity, such as a partnership or corporation, can irrigate with subsidized water. Generally, owned land above this limit cannot be irrigated with federal water,[2] and farmers must pay the "full cost" for water delivered to leased land over the limit.

The concept of full-cost pricing represents a significant departure from prior reclamation law. The full-cost rate is an annual rate intended to repay over time the federal government's expenditures for project construction allocated to irrigation, including unreimbursed operation and maintenance expenses, with interest.

The differences between subsidized and full-cost water rates vary among water projects and districts and are often substantial. For example, in California's Westlands Water District, one of the country's largest water districts, farmers pay about $17 per acre-foot[3] for subsidized water but about $42 or about 2.5 times more at the full-cost rate. In Westlands, a farmer uses an average of about 2.7 acre-feet annually per acre. Thus, irrigating a 960-acre tract for 1 year would cost over

[1]The act limits legal entities benefiting more than 25 persons to receiving subsidized water on 320 acres if water was first received on or before October 1, 1981, and no such legal entity may receive federal irrigation water on more than 640 acres of owned (as opposed to leased) land.

[2]After enactment of the 1982 act, "excess" owned land placed under a "recordable contract" can be irrigated with subsidized water for up to 5 years (10 years in the Central Arizona Project) after which time the land is to be sold as stated in footnote 1. All 10-year recordable contracts that were in effect before the 1982 act are also honored.

[3]An acre-foot is about 326,000 gallons—the volume of water necessary to cover 1 acre to a depth of 1 foot.

$43,000 using subsidized water but about $109,000 at full cost. In the Quincy Water District in the state of Washington, subsidized water costs about $2 per acre[1] while the full-cost rate ranges from $54 to about $73 per acre or 27 to about 36 times more than the subsidized rate. Irrigating a 960-acre farm with subsidized water in Quincy would cost about $1,900 but up to $70,000 with full-cost water.

Water Districts and Farmers Have an Option

The 1982 act gave water districts an option—they could continue receiving irrigation water under their existing contracts and remain subject to prior reclamation law (as amended or supplemented by the 1982 act) or they could receive irrigation water under new or amended contracts and be covered by all provisions of the 1982 act.

For those districts that chose to remain under prior law, the act allowed them to continue delivering subsidized water to unlimited leased acreage for 4-1/2 years from the date of the act. At the end of the 4-1/2 year period (April 12, 1987), districts that had not entered into new or amended contracts to comply with the act were required to charge the full-cost rate for all water delivered to leased land in excess of 160 acres. However, each farmer in those districts has the option of independently electing to receive subsidized water under the act's expanded acreage limits. Water districts can come under the act at any time, even after April 12, 1987. However, once a farmer or district makes the decision to receive subsidized water under the act's expanded acreage limits, it is irrevocable.

For those water districts that chose to enter into new or amended contracts with the Bureau to comply with the act and receive subsidized water under the expanded 960-acre limit, all farmers in those districts were automatically covered by both the increased ownership limitations and pricing requirements of the act. As of July 1988, slightly over half of the water districts subject to acreage limitation had amended their contracts to receive subsidized water under the act's expanded acreage limits.

[1] The Bureau uses two types of contracts for collecting construction, operation, and maintenance costs associated with the irrigation component of its water projects—repayment contracts and water service contracts. Repayment contracts, which are widely used in the Columbia Basin Project, obtain repayment on the basis of the number of acres served with project water. Water service contracts, which are used primarily in the Central Valley Project, obtain repayment on the basis of the amount of project water delivered.

According to a Bureau acreage limitation specialist, about 70 percent of those districts that had not amended their contracts are located in the Bureau's Mid-Pacific Region. Many of these districts have long-term, fixed-rate water service contracts with the Bureau that do not fully recover the federal government's costs of operating and maintaining the water resource projects. These districts are reluctant to come under the act because they would be required to pay full operation and maintenance expenses immediately. By not coming under the act, according to the specialist, these districts help farmers with less than 160 acres (320 acres for married couples), who would not benefit from the expanded acreage limits, by keeping the existing low water rates for the duration of the districts' contracts. Farmers with more than 160 acres can still take advantage of the act's expanded acreage limits by individually electing and paying a rate that is at least sufficient to recover all operation and maintenance expenses.[7]

Objectives, Scope, and Methodology

In a March 23, 1987, letter, the Chairman of the Subcommittee on Water, Power and Offshore Energy Resources, House Committee on Interior and Insular Affairs, asked us to review the Bureau's implementation of the 1982 act. We performed a broad survey and identified various issues for more in-depth review. In subsequent discussions with the Chairman's office, we agreed to focus this review on determining whether (1) the Bureau is implementing the act's acreage limit in a manner consistent with the statute and congressional expectations and (2) large farms have been reorganized since the act to receive subsidized water on acreage that exceeds the legislatively mandated limit and, if so, how they have been reorganized.

We focused our work on the Bureau's Pacific Northwest Region in Boise, Idaho, and Mid-Pacific Region in Sacramento, California. The Bureau identified these regions as having the most acreage that could potentially be subject to the act's full-cost provision. We selected the largest project within the two regions—the state of Washington's Columbia Basin Project in the Pacific Northwest Region and California's Central Valley Project in the Mid-Pacific Region. (See fig. 1.1.) Together, these two projects provided irrigation water to about 3.4 million acres in 1987.

[7]In cases where the contract rates do not fully recover operation and maintenance expenses, the water rates charged farmers electing to take advantage of the act's expanded acreage limits must be increased to recover all operation and maintenance expenses. The Bureau has determined, however, that these rates do not have to recover any of the projects' construction costs.

Figure 1.1: Location of the Bureau Regions and the Two Largest Water Projects in the Western States

Source: Bureau of Reclamation

To help us select farms that might have reorganized to avoid full-cost water payments, we asked the Bureau, as well as water districts in California and the state of Washington, to provide us with lists of farms in the Central Valley Project and the Columbia Basin Project that were larger than 960 acres before the act was fully implemented. We asked that these lists be comprised of farms that operated under farm management contracts, trusts, partnerships, and/or corporations. From these lists we judgmentally selected eight farms (four in each project). The eight cases we chose are not necessarily representative of all large farms throughout the West; rather, we selected them to determine whether farms have reorganized to avoid the full-cost water rates associated with the act's acreage limits. For presentational purposes, we assigned

fictitious names from the Greek alphabet to the farms discussed in this report.

We developed key indicators which any one or more would suggest that individual small landholdings are, in fact, parts of larger farms. Most of these indicators focus on arrangements between and among owners, lessees, and/or farm operators rather than on the individual landholdings. These indicators that suggest landholdings are jointly operated as a single farm are as follows:

- The individual landholdings or other farm assets are combined as collateral for loans.
- The principal owners or lessees of the individual landholdings agree to cover loan defaults of other principals.
- The farm manager or operator bears an economic risk associated with the production and sale of the crops.
- The same individuals make management decisions for multiple landholdings.
- The owners of the farm management company that operates the small landholdings are the same individuals who owned or leased the land before the reorganization occurred.
- The small landholdings are leased from the large farm that existed before the reorganization.
- The same individuals own or lease the small landholdings.
- A single farm management company operates multiple landholdings.
- Crop subsidy records indicate that the landholdings are interrelated.
- The small landholdings share equipment or labor, sometimes without charge.
- The farm manager or operator acknowledges that the small landholdings are being operated collectively as one farm.

We reviewed and analyzed certification forms (forms that landholders file with the Bureau to certify their acreage) to determine how the eight farms had reorganized. We reviewed lease, partnership, and trust agreements; contracts for farm management and other services; county land ownership records; crop subsidy documents submitted to the U.S. Department of Agriculture's Agriculture Stabilization and Conservation Service (ASCS);[7] and water district records to determine whether large farms had been reorganized into smaller landholdings yet continued to

[7]The U.S. Department of Agriculture is authorized by the Agricultural Act of 1949, as amended, to make direct income support payments to farmers under annual commodity and acreage reduction programs for wheat, feed grains, cotton, and rice. ASCS within the Department administers the annual commodity and acreage reduction programs.

operate in much the same manner as they had before. We also interviewed bankers and water district and ASCS officials to further document whether multiple landholdings were being operated together as single, large farms. To confirm this information, we met with the farmers and/or their attorneys.

To determine if the Bureau's rules for implementing the act were consistent with the statute and congressional expectations, we reviewed the act and its legislative history, the Bureau's proposed and final rules implementing the act, and various internal Bureau documents. To assess the Bureau's administration of the act as it applies to our cases, we met with the Department of the Interior's Pacific Southwest Regional Solicitor in charge of reclamation reform matters and officials in the Bureau's Pacific Northwest Region and Mid-Pacific Region. We also met with officials in the Bureau's headquarters in Denver, Colorado, including staff from the Analysis, Contracts, and Lands Division and former Acreage Limitation Branch.

Our case study work was conducted between October 1987 and October 1988. We also reviewed the Bureau's January 1989 report to the Congress on its audits of individual and legal entities whose landholdings or farming operations exceed the act's 960-acre limit.

Our work was performed in accordance with generally accepted government auditing standards. The Department of the Interior provided written comments on a draft of this report. These comments are explained and evaluated in chapter 2 and the text of Interior's comments is included in appendix II.

Current Law and Regulations Allow Farms to Reorganize to Increase Federal Water Subsidies

The Reclamation Reform Act of 1982, as amended, has not stopped federally subsidized water from being delivered to owned and/or leased land over 960 acres being operated as one farm. The act's language and the Bureau of Reclamation's implementing regulations do not preclude multiple landholdings, each of which is within the act's 960-acre limit, to continue to be operated as one large farm while individually qualifying for federally subsidized water. Some farmers have taken advantage of this loophole by reorganizing their farms into multiple smaller landholdings to receive additional federally subsidized water from the Bureau. One consequence has been a reduction in revenues to which the federal government would have been entitled.

Since these reorganized farms do not violate the act's language, Bureau audits of the individuals or legal entities who own or lease individual landholdings probably will find them to be in compliance with the act's 960-acre limit. And, although existing regulations do provide the Bureau with the latitude to charge farm operators who have an economic risk in farming multiple landholdings the full-cost rate for federal water delivered to over 960 acres, it has not done so for two cases included in our review that come under these regulations.

Dichotomy Exists Between Congressional Expectations and the Act's Language

Our review of the 1982 Reclamation Reform Act's legislative history shows that the Congress expected to stop the flow of federally subsidized water to owned and/or leased land over 960 acres being operated as one farm. However, the 1982 act does not preclude multiple landholdings to individually qualify for federally subsidized water while being operated collectively as one large farm.

The act does not limit the size of a farm, but rather the amount of land the government will help a farmer irrigate. Since the Bureau's implementation of earlier reclamation law had evolved into a policy of delivering subsidized water to farms comprised of thousands of leased acres, the Congress wanted the new law to limit the number of acres—either owned or leased—to which the Bureau would deliver subsidized water to any one farm.

The act's legislative history shows that two successive Congresses debated over the requisite size of an economically viable farm while agreeing that the turn of the century limit of 160 acres was too small. The Senate bill called for the acreage limit to be set at 1,280; the House bill called for 960. Ultimately, the conferees agreed that a farm should receive subsidized water on no more than 960 acres.

The act's legislative history demonstrates the congressional expectation that federally subsidized water would be limited to no more than 960 acres of owned and/or leased land being operated as one farm. The conference report that accompanied the act stated that both the Senate and House agreed to reduce the subsidy for "larger farming operations" and that the benefits of the new law should be available only if a water district agreed to amend its contract with the Bureau to reduce the subsidy for farming operations exceeding 960 acres.

Conferees several times affirmed their expectation that large farms would receive federally subsidized water on only 960 acres. For example, the Chairman of the House Committee on Interior and Insular Affairs said:

"We're saying we're going to have a 960 acre basic limitation of farms . . . anybody above that pays full cost."

The act, however, defines and uses the term "landholding" rather than the term "farm" or "farming operation" in establishing the maximum acreage an individual or legal entity can irrigate with subsidized water. A landholding is defined in the act as the

"total irrigable acreage of one or more tracts of land situated in one or more districts owned or operated under a lease [by individuals or entities] which is served with irrigation water pursuant to a contract with the Secretary."

The act is silent on whether multiple landholdings can operate together as one large farm while qualifying individually for federally subsidized water on up to 960 acres.

The Bureau's Implementing Regulations Mirror the Act's Statutory Language

The Bureau first published proposed regulations to implement the Reclamation Reform Act in May 1983. However, the regulations did not address section 203(b) of the act, commonly called the "hammer clause." This section mandated that after April 12, 1987, parties remaining subject to prior law must pay the full-cost rate for water delivered to land leased in excess of 160 acres. Final regulations to implement the act (absent section 203(b)) were published in December 1983.

The Bureau published proposed regulations to implement section 203(b) in November 1986. These regulations also reflected policy initiatives and legal determinations that impacted on the earlier published regulations. According to the Commissioner of Reclamation, these regulations

were developed with the purpose of accomplishing congressional intent. However, the Bureau subsequently decided to revise its regulations to reflect its reading of the act, rather than congressional expectations.

In an April 1987 speech presented to a large group of western water users just after the Bureau had published its final regulations, the Commissioner outlined the Bureau's approach:

"The first set of rules attempted to capture the purposes of that law. We listen[ed] to and studied extensively what . . . Congress and the Senate intend[ed], what was the congressional intent in passing this law . . . when you listen to the dialogue [it] was much different than you can get with a strict statutory constitutional interpretation of what the law itself says."

The Commissioner continued that the Bureau based its final regulations on the act's statutory language because (1) the public, in commenting on the proposed regulations, expressed conflicting views on what the law required and (2) Interior's Solicitor advised the Bureau that the act's language required the Secretary to promulgate regulations to carry out the act's specific provisions. The Solicitor based his advice on (1) section 224(c) of the act which states that "The Secretary may prescribe regulations and shall collect all data necessary to carry out the provisions of this title and other provisions of Federal reclamation law" and (2) a comparison with other laws that grant the Secretary authority to promulgate regulations. The Solicitor found that other laws empower the Secretary to carry out the act's purposes whereas the Reclamation Reform Act has no such provision and does not include a stated purpose. Thus, the Commissioner decided to base the Bureau's implementing regulations on the law as written rather than on congressional expectations reflected in the act's legislative history, and the regulations permit multiple landholdings of not over 960 acres to receive federally subsidized water even if they are being operated collectively as one large farm.

Some Farmers Are Receiving Federally Subsidized Water on More Than 960 Acres

In two of the eight cases we selected, the farmers who had previously farmed large acreages had divested themselves of their leased land above 960 acres before April 1987 consistent with congressional expectations. However, applying the key indicators that we developed to focus on arrangements between and among owners, lessees, and/or farm operators, we found that in the six other cases, the owners or lessees had reorganized large farms into multiple, smaller landholdings and consequently were eligible to receive additional federally subsidized irrigation water from the Bureau. The indicators suggest that for all practical

purposes, these smaller landholdings, which generally are within the act's 960-acre limit, continue to be operated collectively as single large farms, much as they were before being reorganized.

Reorganizing Through a Combination of Partnerships, Corporations, and Trusts

Three of the six cases involved large farms that were reorganized through partnerships, corporations, and/or trust arrangements in order to receive subsidized water on more than 960 acres. For example, a 12,345-acre cotton farm (roughly 20 square miles), operating under a single partnership, was reorganized into 15 separate landholdings through 18 partnerships, 24 corporations, and 11 trusts. All of the 15 landholdings were eligible to receive subsidized water on land up to 960 acres. Indicators that the 15 landholdings continue to be operated as one large farm include (1) the four original partners continue to manage all 15 landholdings, (2) at least one of the four partners is either the president or vice president of the corporations that participate in the agricultural business decisions of nine of the landholdings totaling about 8,000 acres, and (3) the 15 landholdings are operated with a single loan secured in common by their combined crops and other farm assets.

Reorganizing the Family Farm Through a Partnership

In another case study, four members of a family certified to the Bureau that the 4,638 acres they owned or leased were actually four separate landholdings. Indicators that the family continues to operate the landholdings as one large farm include (1) the four landholdings were combined as collateral for an operating loan and (2) a single company owned by the family members manages all four landholdings.

Organizing Through Partnerships and Limited Partnerships

Similarly, a 1,569-acre citrus and almond orchard was organized into four smaller landholdings through four partnership and three limited partnership arrangements. The four partnerships not only have a single operating loan with the four landholdings used as collateral, but also (1) the four partnerships agreed to cover each others' mortgage loan defaults, (2) the only general partner (shared by all three limited partnerships) makes the management decisions for the four landholdings, and (3) a farm operator manages the four landholdings under a series of farm management agreements covering different farming activities.

Reorganizing Through a Trust

In the sixth case, 10 family members had put their land into a revocable trust (one which they can dissolve at any time) that controlled 3,116 acres and made themselves beneficiaries of all income the trust will

derive. Although the family farmed less than 960 acres in 1987, the trust they established enables them to irrigate the entire 3,116 acres with federally subsidized water in the future.

The act exempts from its 960-acre limit lands held for beneficiaries by a trustee in a fiduciary capacity as long as no one beneficiary's interest exceeds the law's ownership limits. The act, as amended in 1987, also requires that land held in a revocable trust be attributed to the grantors. The 1987 amendment was meant to ensure that large landholdings are not placed in trust with multiple beneficiaries to meet the act's requirement that no one beneficiary's interest exceeds 960 acres only to be later revoked with the landholdings reverting back to the grantors. Since there are 10 family members and the farm is comprised of 3,116 acres (or about 312 acres per member), they meet both of the act's requirements. And, if they should dissolve the trust at any time, the land would simply revert back to themselves as the grantors.

Farm Reorganizations Are Reducing Federal Revenues

One consequence of owners and lessees reorganizing large farms into multiple, smaller landholdings to be eligible to receive additional federally subsidized irrigation water from the Bureau has been a reduction in revenues to which the federal government would have been entitled. As table 2.1 shows, in four cases the owners or lessees paid a total of about $1.3 million less in 1987 for federal water delivered by the Bureau than they would have paid if their respective multiple landholdings had been considered collectively as large farms subject to the act's 960-acre limit. Since the cases we reviewed were selected only to determine whether farms have been reorganized to increase federal water subsidies and, therefore, are not projectable, we are not able to estimate the total federal revenues being foregone because of reorganizations. However, reduced revenues likely will continue to occur annually under the existing act.

Table 2.1: Summary of Eight Case Studies

Case number	Actual acreage of large farm	Equivalent class I acreage[a]	Post-Act Reorganization: Number of small landholdings established	Post-Act Reorganization: Organizational structure	Revenues to which government would have been entitled in 1987
1	12,345	11,065	15	18 partnerships 24 corporations 11 trusts 24 individuals	$551,000
2	4,638	2,553	4	1 partnership 4 individuals	56,000
3	1,569	1,569	4	7 partnerships 1 individual	0
4	3,116	3,116	1	1 trust 10 individuals	0
5	8,035	8,035	7	7 partnerships 25 corporations 4 trusts 7 individuals	522,000
6	4,585	3,320	7	3 partnerships 2 corporations 1 trust 1 estate 10 individuals	144,000
7[b]	1,482	806	1	1 individual	0
8[b]	3,050	1,751	2	3 individuals	0
Total					**$1,273,000**

[a]The 1982 act recognizes that there are differences in the potential productivity of the land on which federal irrigation water is delivered and provides for acreage equivalency determinations. Land is classified on the basis of such factors as topography, soil characteristics, growing season, and crop adaptability, with class I land having the potential to be the most productive and class III land having the potential to be the least productive. A farmer can irrigate up to 960 acres of class I land with federally subsidized water while another farmer in the same water district can irrigate considerably more of class III acreage. Generally, the equivalency ratios applied to determine the acreage eligible for federally subsidized water are determined on a project by project basis.

[b]During our work, Bureau officials informed us that they would direct the responsible water district to collect the full cost rate for water delivered to 609 of the 1,569 acres in 1987 and 1988. We estimate that this would have entitled the federal government to an additional $21,000 in 1987 alone. However, in a May 1989 letter to the Bureau, the water district stated that its final audit of water supplies showed that sufficient nonfederal water was available in both 1987 and 1988 to irrigate all the acreage not eligible for federally subsidized water.

[c]Although the 10 individuals farmed less than 960 acres in 1987 under existing reclamation law, the trust they established enables them to irrigate the entire 3,116 acres with federally subsidized water in the future.

[d]In case studies 7 and 8, the farmers who had previously farmed the acreage divested themselves of their leased land above 960 acres before April 1987, consistent with congressional expectations.

Table 2.1 also summarizes key information on the eight cases we selected. All eight had been operated as large farms before the 1982 act was fully implemented. Appendix I provides a case study for each of the

four types of reorganizations and arrangements discussed in this chapter.

Bureau Audits Will Likely Continue to Find General Compliance With the Act's 960-Acre Limit

Concerned that some farmers are not complying with the 1982 act's acreage limits, the Congress amended the act in 1987 to require the Secretary of the Interior, by December 22, 1990, to complete audits of individuals and legal entities[1] whose landholdings or farming operations exceed 960 acres. The Bureau is to report annually to two congressional committees on its findings and actions taken to correct instances of noncompliance.

Since the act's statutory language and the Bureau's implementing regulations do not preclude multiple landholdings to continue to be operated as one large farm while individually qualifying for federally subsidized water, the Bureau's 1988 audits of selected landholdings found the individuals and legal entities who are the owners or lessees of the land to be in general compliance with the act's 960-acre limit. This finding was conveyed to the cognizant committees of the Congress in the Bureau's first annual report, issued in January 1989; and the Bureau's audits of individual landholdings will likely continue to find general compliance with the act, even though some landholdings are, in reality, parts of larger farms.

During 1989 and 1990, the Bureau will also audit farming operations. Under the Bureau's regulations, an agreement between a farm operator and the owner(s) or lessee(s) to manage a farm is considered a lease when the agreement gives the farm operator use and possession of the land and an economic risk in its operation. If the Bureau determines that the economic risk of farming has shifted to the farm operator, the farm operator then becomes the lessee and should pay for all federal water delivered, including the full-cost rate for water delivered over the 960-acre limit.

We believe that at least two of our case studies meet the Bureau's economic risk criterion. In one case study, four family members have reorganized a 4,638-acre farm into four separate landholdings and have contracted with themselves to farm their own land. We believe that, as the farm operators, they have use and possession of the land and clearly have an economic risk in its operation. In the second case study, the sole

[1]Bureau regulations define legal entities as those business or property ownership arrangements established under state or federal law, such as partnerships, corporations, and tenancies.

owner of an 1,569-acre orchard, organized into four separate landholdings, has contracted with a farm operator to manage the orchard. Under the terms of the farm management agreements, the farm operator has assumed the economic risk associated with the production and sale of the crops, and we believe that the agreements should be considered a lease under Bureau regulations. However, in both cases the Bureau continues to provide the entire acreage with federally subsidized water because it remains unconvinced that the economic risk of farming has shifted to the farm operators. Thus, on the basis of its determinations to date, we believe that the Bureau will not exercise the latitude it has under existing leasing regulations to charge some farm operators the full-cost rate for federal water delivered to over 960 acres and that its audits of farming operations will find them to be in general compliance with the act's acreage limit.

Conclusions

The Reclamation Reform Act's legislative history shows that the Congress expected the Bureau to provide federally subsidized water to a maximum of 960 acres of owned and/or leased land being operated as one farm. Generally, owned land above this limit cannot be irrigated with federal water, and farmers must pay the full cost for water delivered to leased land over the 960-acre limit. The act, however, defines and uses the term "landholding" rather than the term "farm" or "farming operation" in establishing the acreage limit and is silent on arrangements that permit multiple landholdings to operate together as one large farm while qualifying individually for federally subsidized water up to 960 acres. The Bureau's implementing regulations also allow multiple landholdings of not more than 960 acres to individually qualify to receive federally subsidized water even if they are being operated as one large farm.

Some farmers have reorganized their farms into smaller landholdings which generally are within the act's acreage limit using various partnerships, corporations, and/or trust arrangements. These landholdings continue to be operated collectively as large farms while qualifying individually for federal water subsidies.

In four of the cases we reviewed, the owners or lessees were able to pay a total of about $1.3 million less in 1987 for the federal irrigation water delivered than they would have paid if their respective multiple landholdings had been considered collectively as large farms subject to the act's 960-acre limit. This $1.3 million represents reduced revenues to which the federal government would have been entitled, and these

reduced revenues likely will continue to occur annually unless the act is amended.

The Bureau's audits of individual landholdings have found and will likely continue to find them to be in compliance with the act's 960-acre limit, as will its audits of farming operations. As a result, for the cases included in our review no one is being required to pay the full-cost rate for any of the federal water being delivered to large farms and farming operations.

We recognize that the Congress could not have envisioned all the different types of reorganizations and arrangements that have developed in the act's aftermath. In our view, farm reorganizations and other arrangements that allow multiple landholdings to continue to be operated as parts of large farms while individually qualifying for federally subsidized water are not consistent with what we believe the Congress was trying to accomplish in establishing the 960-acre limit.

Recommendation to the Congress

If federally subsidized water to a given farm, farming operation, or landholding is to be limited to no more than 960 acres of leased and/or owned land, we recommend that the Congress amend the Reclamation Reform Act of 1982 to apply the act's acreage limits to farms and farming operations as well as to individual landholdings. Specifically, we recommend that the Congress amend

- section 202 to add a definition of farm or farm operation as follows: "The term 'farm' or 'farm operation' means any landholding or group of landholdings farmed or operated as a unit by an individual, group, entity, trust, or any other combination or arrangement. The existence of a farm or farm operation will be presumed, subject to contrary evidence, when ownership, operation, management, financing or other factors, individually or together, indicate that one or more landholdings are farmed or operated as a unit;"
- section 203 to include a farm or farm operation in the 160-acre limit now applicable only to a landholding;
- section 205 to include a farm or farm operation in the pricing provisions now applicable only to a landholding;
- section 214 so that the ownership and pricing limitations of reclamation law will apply to a farm or farm operation operated by or for a trustee for one or more beneficiaries; and
- section 228 to require reporting by a farm or farm operation.

Agency Comments and Our Evaluation

Interior agreed that some farmers have reorganized their farms into smaller holdings to maintain large farming operations while complying with the Reclamation Reform Act's acreage limits and that legislative restrictions resulted in implementing regulations that permit multiple landholdings to continue to be operated as one large farm while individually qualifying for federally subsidized water. Interior also agreed that the act must be amended if the amount of acreage that a farm operator may hold and irrigate with federally subsidized water is to be limited.

Interior cautioned that while it agreed that the Congress clearly intended to stop the flow of federally subsidized water to land over 960 acres owned or leased by one individual, it is not convinced that the Congress expected this provision to be applied to land being operated as one unit. We believe that by amending the act as we recommend, the Congress will ensure that the Bureau will provide federally subsidized water only to a maximum of 960 acres of owned and/or leased land being operated collectively as one farm.

Interior states, and we agree, that the act was not intended to enhance federal revenues. However, a reduction in revenues to which the federal government would have been entitled is one consequence of owners and lessees reorganizing large farms into multiple, smaller landholdings to be eligible to receive additional federally subsidized irrigation water from the Bureau. On the basis of our case studies, we also agree with Interior that if the act is amended to apply the acreage limits to farms and farming operations as well as to individual landholdings, some farmers will reorganize their farms further in an attempt to avoid being assessed the full cost for water delivered. However, with a clear mandate from the Congress to stop federally subsidized water from being delivered to owned and/or leased land over 960 acres being operated as one farm, we would expect the Bureau to find farms that have been reorganized further to avoid paying the full cost for water delivered to be not in compliance with the act's 960-acre limit. Further, if our recommended amendment results in these farmers subsequently divesting themselves of their holdings over 960 acres as Interior contends, then it will have accomplished the Congress' expectation in passing the 1982 act to put an end to the Bureau providing federally subsidized water to farms consisting of thousands of acres.

Interior agreed that the Bureau's audits will likely continue to find general compliance with the act's 960-acre limit but stated that our implication that the Bureau will not find any major compliance problems is less than accurate. Interior stated that the Bureau has found various

instances of noncompliance and that in other cases farm operators and owner(s) or lessee(s) have been required to alter their agreements to continue to be eligible to receive federally subsidized water. We did not state nor mean to imply that the Bureau's audits will not find any major compliance problems. Rather, our report points out that the Bureau's finding of general compliance is due, in part, to (1) the act's statutory language and the Bureau's implementing regulations not precluding multiple landholdings from continuing to be operated as one large farm while individually qualifying for federally subsidized water and (2) the Bureau not exercising the latitude it has under existing regulations to charge farm operators who have an economic risk in farming multiple landholdings the full-cost rate for federal water delivered for over 960 acres.

Types of Reorganizations and Arrangements: Four Case Studies

Reorganizing Through a Combination of Partnerships, Corporations, and Trusts

Three of the cases we selected involved large farms that were reorganized through partnerships, corporations, and/or trust arrangements in order to receive subsidized water on more than 960 acres. For example, in one case, a 12,345-acre farm (roughly 20 square miles) was reorganized into 15 separate landholdings, involving an elaborate network of partnerships, corporations, and trusts. Five indicators showed that after the farm was reorganized, the 15 landholdings continued to be operated as one large farm:

- one partnership leased 12,345 acres, and then subleased portions of it to other new partnerships;
- the partners[1] obtained one operating loan secured by the farms' crops and other assets;
- ASCS crop subsidy records indicate that the landholdings are interrelated;
- two farm management companies operate all 15 landholdings; and
- four individuals make the management decisions for nine of the 15 landholdings.

Before electing to receive subsidized water under the act's expanded acreage limits, Alpha Farms partnership, one of California's leading cotton producers, leased 12,345 acres (equivalent to 11,065 acres of class 1 land) as a single farm. Two pairs of brothers originally formed Alpha Farms partnership in 1982.

In February 1986, Alpha Farms partnership was reorganized. The new Alpha Farms partnership consisted of 16 partners, two of which were partnerships and 14 of which were corporations. After the reorganization Alpha Farms partnership was controlled by 20 individuals through the partnerships and corporations (nine of the individuals were represented through trusts for minor children and four were the original partners). In July 1986, Alpha Farms partnership obtained an operating loan, secured by the 16 partners' crops and other farm assets.

In January 1987, Alpha Farms partnership leased about 5,000 acres to Beta I Farms Partnership but the acreage continued to be operated as one farm. Beta I Farms Partnership had 15 partners, consisting of 1 limited partnership, 4 trusts, and 10 corporations. The 15 partners were controlled by 9 individuals, 4 of whom were represented through trusts. Two of the individuals are the fathers of the original partners of Alpha

[1] A "partner" in a given partnership can be a corporation, trust, individual, or even another partnership.

Farms partnership and a third was associated with the Alpha Farms partnership.

On May 12, 1987, after the 1987 irrigation season began, Alpha and Beta I Farms reorganized into 15 separate landholdings by creating 13 new partnerships. Both farms subleased portions of their land to the 13 newly created partnerships, with only one landholding larger than 960 acres of class I equivalent land.

Although Alpha and Beta I Farms divided into 15 smaller landholdings (Alpha Farms I-IX and Beta Farms I-VI), the partners remained the same. Now, instead of 31 partners (3 partnerships, 24 corporations, and 4 trusts) controlling 2 large farms, they control 15 smaller landholdings.

Also on May 12, 1987, Alpha Farms I-IX and Beta Farms I-VI elected to come under the provisions of the Reclamation Reform Act and its expanded acreage limits. In so doing, all of the 15 landholdings were eligible to receive subsidized water on up to 960 acres of class I equivalent land. However, even after reorganizing and electing to come under the act, the 15 landholdings continued to be operated as 1 large farm.

The 4 original partners continued to farm all 15 landholdings under custom farming agreements.[2] Under these agreements, two farm management companies, owned primarily by the four partners, farmed all the land by providing labor and equipment, and by tilling, seeding, cultivating, irrigating, and harvesting. In addition to controlling the actual farming of all the land, at least 1 of the 4 original partners was either the president or vice president of each of the Alpha corporations that were also partners in the Alpha landholdings and, therefore, could make the agricultural business decisions for 9 of the 15 landholdings. Moreover, the 15 landholdings continued to be operated under the same single loan obtained in July 1986.

Papers filed with ASCS to receive additional crop subsidies documented that the two farms were divided into 15 smaller landholdings to maximize the federal water subsidies they receive. ASCS crops subsidy records also provided additional evidence that the 15 landholdings were operated as a single farm. In 1987, before electing to receive subsidized water under the act's 960-acre limit, Alpha and Beta I Farms applied for

[2]Custom farmers are hired to perform services on a farm, such as harvesting a crop, on a unit-of-work basis (e.g., $25 per acre harvested).

ASCS crop subsidies as two farms. After subdividing into 15 smaller landholdings, ASCS continued to consider Alpha and Beta I as two, rather than 15 farms. To qualify for the ASCS subsidies, Alpha and Beta I Farms were required to take about 2,200 acres out of production. In designating the idle acreage, Alpha designated about 102 acres of Beta I's land, and Beta I designated about 380 acres of Alpha's land.

Reorganizing the Family Farm Through a Partnership

In this case study, four members of a family—father, son, and daughter and her husband—each owned acreage and, together with leased acreage, managed their landholdings as Gamma Farms partnership, a 4,638-acre farm (equivalent to 2,553 acres of class I land). In July 1987, the Gamma family filed Bureau certification forms as four separate landholdings—one controlled by each of the family members and one by the Gamma Farms partnership. Each landholding consisted of less than 960 acres of class I-equivalent land, allowing it to receive subsidized water on the entire acreage. However, the family continued to operate the four landholdings as one farm.

We identified the following indicators that showed that the Gamma Farms partnership continues to operate the 4,638 acres as one farm:

- the four landholdings were combined as collateral for an operating loan,
- a single farm management company owned by the Gamma family operates all four landholdings,
- the farm manager acknowledges that the landholdings are being operated as one farm, and
- the farm manager bears an economic risk in the operation of more than 960 acres.

The Gamma family grows primarily potatoes on 4,638 acres, irrigated with subsidized water. From 1982 to July 1987, they farmed this land as Gamma Family Partnership.

In March 1986, the Gamma family obtained a single $5 million operating loan. Each of the family members signed the loan, and each put up his or her individual landholdings as collateral. Mr. Gamma later told us that the bank would not provide the financing unless the Gammas combined their landholdings as collateral. This loan continued to provide financing in 1987, after the family had elected to receive subsidized water under the act's 960-acre limit.

In July 1987, Gamma Farms partnership contracted to manage the other three landholdings; that is, the Gamma family contracted with themselves to farm their own land. They wrote the contracts so that each, as a landholder, retained the right to make agricultural business decisions, such as what crop to grow, how much acreage to devote to a particular crop, and how crops are to be rotated. As farm managers of all four landholdings, the Gamma family would perform the actual farming. Their contracts require that they provide the necessary labor and equipment and do the seeding, cultivating, tilling, and harvesting.

The contracts clearly state that the role of landholder and farm manager would remain separate. As such, Mr. Gamma had to sign each of the farm management contracts as the manager of Gamma Farms partnership, including one that he also had to sign as the landholder. In doing so, he agreed that he would keep these roles separate and that as the owner, he would make the agricultural business decisions and as the manager, he would make the farm management decisions.

According to Mr. Gamma, the four landholdings were being operated as one farm. He said that the four landholdings were reported to the Bureau as four separate landholdings to continue receiving subsidized water from the Bureau on all the land and that he intended to continue operating the family's landholdings as one farm.

We believe that since the Gamma Farms partnership is leasing the entire 4,638 acres under farm management agreements with the other three landholders, the Bureau should charge the full-cost rate for all water delivered to more than 960 acres of class 1 land. According to Bureau regulations, a farm management agreement is considered a lease when a party has use and possession of land and assumes an economic risk in the operation of that land. As the farm manager, Gamma Farms partnership has use and possession of the land and clearly has an economic risk in its operation. However, the Bureau continues to provide the entire acreage with federally subsidized water because it remains unconvinced that the economic risk of farming has shifted to the farm management company.

Organizing Through Partnerships and Limited Partnerships

In another case study, a 1,569-acre citrus and almond orchard was organized into four smaller landholdings through four partnership and three limited partnership agreements. Four indicators showed that these four landholdings continue to be operated as one large farm:

- the four partnerships had a single operating loan with all four landholdings used as collateral,
- each partnership agreed to cover the mortgage loan defaults of the other partnerships,
- one general partner (shared by all three limited partnerships) made the management decisions for the four landholdings, and
- the farm operator bore an economic risk in operating the entire 1,569 acres.

Before November 1986, a major insurance company owned the Delta Farms orchard. During November, the company sold the orchard as four separate landholdings. A different partnership bought each landholding and each partnership filed Bureau certification forms as separate landholdings, making each eligible to receive subsidized water on its entire acreage.

Financing obtained by the four partnerships showed, however, that each was dependent on the others. For example, even though they secured separate mortgages for their respective landholdings, totaling about $7 million, each partnership agreed that if any of the others failed to meet its repayment obligations, the remaining partnerships would cover the default. Second, the four partnerships joined together to obtain a single $1.2 million operating loan, for which all four landholdings served as collateral.

The four partnerships that purchased Delta Farms were jointly owned by three limited partnerships that shared the same general partner. Each limited partnership agreement permitted up to 25 partners, with the general partner owning no more than 26 percent, or a combined total of about 400 acres.

Under the three limited partnership agreements, the general partner makes all the management decisions and has total control of the four partnerships' management and assets. Limited partners are strictly investors and do not participate in managing the partnerships.

The general partner of the orchard contracted with a farm operator to manage the four landholdings under a series of farm management agreements covering different farming activities. For example, one agreement required the operator to irrigate, fertilize, prune, and control weeds in the orchard. Another covered the harvesting of the crops. Although each of the agreements was with a separate farm management company, each company was controlled by the same individual. All of the farm management agreements were signed by this individual as president of each company and covered the operations of the entire 1,569 acres. Moreover, two of the agreements referred to the four partnerships collectively as "the Grower," and not as separate entities.

The sale and purchase agreement stipulates that the farm operator will annually purchase the crops. Another agreement stipulates that the farm operator will offer loans to the owner to cover cash shortfalls if the annual crops do not generate sufficient cash flow to adequately compensate the owner for using the land. For example, this agreement includes provisions for the farm operator to provide the owner with loans of up to $5 million. The loans are to be secured by a lien against the combined real property of the four orchards.

Under the terms of the agreements, the farm operator assumed the economic risk associated with the production and sale of the crops. Therefore, we believe that according to Bureau regulations, the farm operator is, in effect, leasing the 1,569 acres because he has use and possession of the land and an economic risk in the farming operation. As a result, the Bureau should charge the farm operator as a lessee the full cost for the water delivered to acreage above the act's 960-acre limit. However, the Bureau believes that the agreements as written do not clearly demonstrate that the farm operator has assumed the economic risk and, therefore, continues to provide federally subsidized water to all four landholdings.

Reorganizing Through a Trust

A fourth case study involves a 3,116-acre Epsilon family farm that was receiving subsidized water before the act's acreage limits took effect. The family placed their owned land in a trust. Although the family farmed less than 960 acres in 1987, the trust they established enables them to irrigate all 3,116 acres with subsidized water in the future. According to both the trustee and the attorney who arranged the trust, one of the reasons the Epsilons formed the trust was to provide the family the option of operating all the acreage as one farm without paying the full-cost rate for any irrigation water.

Before electing to receive subsidized water under the act's 960-acre limit, 10 members of the Epsilon family jointly owned 2,956 acres and leased 160 acres in two of California's Central Valley Project water districts. In 1987, they transferred their owned land into a revocable trust—one which they could dissolve at any time. The family members granted their land to the trust and also made themselves the beneficiaries of all income the trust would derive.

The act exempts from its acreage limits lands held for beneficiaries by a trustee in a fiduciary capacity as long as no one beneficiary's interest exceeds the law's ownership limits. The act, as amended in 1987, also requires that land held in a revocable trust be attributed to the grantors. The 1987 amendment was meant to ensure that large landholdings are not placed in trust with multiple beneficiaries to meet the act's requirement that no one beneficiary's interest exceeds 960 acres only to be later revoked with the landholdings reverting back to the grantors. Since there are 10 members in the Epsilon family and the farm is comprised of 3,116 acres (or about 312 acres per member), they meet both of the act's requirements. If the Epsilons should dissolve the trust, the land would simply revert back to themselves as the grantors.

According to the Bureau, the trust meets the act's requirements. The Bureau has reviewed the Epsilons' trust arrangement and expects to approve it after certain technicalities are corrected.

Comments From the Department of the Interior

United States Department of the Interior

OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20240

AUG 14 1989

Mr. James Duffus III
Director, Natural Resources
Management Issues
United States General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Duffus:

We have reviewed your draft report entitled "Water Subsidies: Basic Changes Needed to Avoid Abuse of the 960-Acre Limit" (GAO/RCED-89-147) and would offer the following comments.

In general, we agree with the finding of the report that some farmers have reorganized their farms into smaller holdings in an effort to maintain large operations while complying with the Reclamation Reform Act of 1982's (RRA) acreage entitlements. As your report highlighted, the legislative restrictions the Bureau of Reclamation (Reclamation) faced when it crafted the rules and regulations to implement the RRA, permitted some of these landholdings to continue to be operated as large farms. The most important of these legislative restrictions was the use of the term "landholding," which includes only owned and leased land and not "operated" land. We agree with the report's conclusion that if it is Congress' intent to limit the amount of acreage that a farm operator may hold and irrigate with subsidized water, then the RRA must be amended.

However, we would like to state that while we agree that Congress clearly intended to stop the flow of federally subsidized water to land over 960 acres owned or leased by one individual, we are not convinced that Congress expected this provision to be applied to land being "operated" as one unit. During Congress' efforts to enact the RRA, at least one attempt was made in an early reclamation reform bill to address farm management agreements. This bill stated that the Secretary would have the discretion to impose by rule a limitation on the number of landholdings that may be managed on behalf of a qualified recipient by another person (see section 3(d) of Senate Bill 14, 96th Congress, enclosed). This language did not survive committee consideration. Moreover, Congress amended the RRA in 1987 and again chose not to address this issue.

We would like to stress our view that the purpose of the RRA was not to enhance revenues (in the form of full-cost payments) to the Federal Treasury. The report could lead readers to believe that if Reclamation had promulgated rules and regulations that reflected the intent of Congress (that is, the intent as ascertained by the General Accounting Office), more revenues would have been collected. However, the fact is that under more strict

interpretation of the leasing restrictions, and where full-cost rates are significantly higher than contract water rates, it is very likely that operating entities would further reorganize or even divest themselves of their holdings in order to avoid assessment of full-cost charges. It is uncertain that a more strict application would result in increased revenues to the United States.

Your report also states that Reclamation audits will likely continue to find general compliance within the 960-acre limit. While in general this is true, the General Accounting Office's implication that Reclamation will not find any major compliance problems is less than accurate. We have found various instances of noncompliance, many of which have resulted in the application of the underpayment provision. The comments included within the report were probably directed toward leasing/farm management issues; however, the report should not give the impression this is the only important issue in RRA compliance. In any event, we would like to note that through our compliance efforts we have discovered situations in which landowners are not involved in day-to-day management, and leases do not exist, but there are also no acceptable farm operating arrangements. In such cases, the involved parties have been required to alter their arrangements in order to be eligible to receive Federal irrigation water.

As for the specific cases included within the report, Reclamation will perform audits on these operations as part of its scheduled Program Evaluation activities. We would like to state that our information indicates that there are a number of limited partners associated with "Delta Farms," while your report states that there are no limited partners, and therefore, gives an impression that one person owns and is receiving project irrigation water on over 1,500 acres.

We have enclosed a listing of factual errors that were found during our review of this report and some editorial comments that should be considered.

Sincerely,

Assistant Secretary
for Water and Science

Enclosures

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